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SUBJECT: IMF UKRAINE PROGRAM IN JEOPARDY

REF: A. KYIV 419  
[1](#)B. KYIV 406

Classified By: AMBASSADOR WILLIAM B. TAYLOR, REASONS 1.4 (B) AND (D)

[1](#)1. (C) Summary. In the presence of G7 ambassadors and the World Bank, the Kyiv-based IMF resident representative told PM Yulia Tymoshenko on March 5 that there would be "little benefit" in the mission team returning to Ukraine without greater progress on the Fund's conditionalities. Despite a recent declaration of political unity by President Yushchenko, the PM, and other senior officials, the IMF cited a lack of political will to implement necessary measures, calling on Ukraine to "help itself first." The PM appealed for understanding, asking the assembled group to take into account Ukraine's "special (political) circumstances" that "will not change." Appearing unusually haggard and short tempered, the PM admitted that it would be a "tragedy" if Ukraine failed to renew its cooperation with the IMF. The PM focused on solutions for bringing Ukraine into compliance with its IMF commitments, though her ideas were well-worn and materially at cross-purposes with the Fund's overall goals. End summary.

[1](#)2. (C) In the face of what may be a larger than projected fiscal deficit, increased deposit withdrawals from already teetering banks, and rising unemployment and corporate defaults, Ukraine's leaders cobbled together a "joint declaration" on March 3 in order to placate the IMF's calls for greater political unity. Max Alier, the IMF's residential representative in Kyiv, told the PM in front of G7 ambassadors and the World Bank that the Fund had been encouraged by "signs of renewed political cooperation" by the newly constituted Anti-Crisis Working Group. The joint declaration, a one page document forwarded to us by Presidential aide Oleksander Shlapak before it was signed, pledged that the group would take three actions: 1) develop a tax and fiscal policy to match available external financing; 2) gradually introduce a flexible exchange rate to soften the impact of external shocks; and 3) engage in the comprehensive reconstruction of the banking sector, aimed at renewing financial stability.

[1](#)3. (C) While Yushchenko, Tymoshenko, and other principals made good on their promise to put forward a declaration of their willingness to adhere to IMF conditionalities, Alier was downcast about the lack of political will to implement the full IMF program. In particular, he cited the Working Group's other compromise pact, a draft Letter of Intent (LOI) to the IMF. Alier said that the LOI "falls short" on key steps needed to bring the mission team back to complete its review, necessary for the disbursement of the IMF's next \$1.8

billion loan tranche. The lack of specific dates and prior actions referenced by the LOI has provided "little assurance" that Ukraine had fully committed to IMF program conditionalities, according to Alier.

¶4. (C) Ukraine must "help itself first," said Alier, an opinion that was also apparently expressed to President Yushchenko in a letter from IMF Managing Director Strauss-Kahn this week. Alier reiterated that in order to bring the Fund back, the country's leaders must take urgent "fiscal corrective action" to generate savings of at least 2 percent of GDP. Alier affirmed that progress on a bank resolution strategy had been slow, even though the diagnostic studies of the first two groups of Ukraine's banking sector had been completed. It remains essential, according to Alier, to put together a sound framework to address the banking sector, as loan quality had rapidly deteriorated and an average of \$3.75 billion (UAH 30 billion) per month had been withdrawn from banking deposits since the crisis began. It would not take long for the banking system to succumb, projected the IMF representative.

¶5. (C) Commenting to Alier that she "got the message," the PM told the group that she saw two options: early parliamentary elections or a higher budget deficit -- perhaps 10 percent of GDP. Early elections would take 5-6 months. (Comment: We think that a budget deficit of 10 percent of GDP would be extraordinary, given that Ukraine cannot finance its current deficit equivalent to at least 5 percent of GDP. End comment.) The PM pointed to other countries worldwide that had resorted to large budget deficits in order to stimulate their economies. To garner financing, the PM expected that she could borrow externally or raise gas prices for industrial consumers. She was also actively courting partners for the privatization of Ukrtelecom, Odessa Portside Plant, and regional electricity generation plants (so-called oblennergos). Privatization would not require any legislation, though President Yushchenko continues to oppose the idea, said Tymoshenko. The PM projected that privatizing these assets would yield at least \$1.5 billion (UAH 12 billion), and she said that the French Ministry of Finance had confirmed its interest in a partnership for the purchase of Ukrtelecom during her recent visit to Paris. (Note: President Yushchenko and others have opposed privatization efforts, citing market deterioration and concerns that an asset "fire sale" would run counter to Ukraine's medium to long-term interests.)

¶6. (C) Based on recent revenue projections for the current 2009 budget, Alier stated that Ukraine's fiscal deficit would likely exceed the 5 percent of GDP originally estimated by the IMF. In turn, the PM commented that she was disheartened that measures to cut the deficit had not passed in the Rada. Tymoshenko acknowledged that the March 3 defeat of a bill that would have brought substantial savings to the Pension Fund had raised concerns for the IMF, though she blamed OU/PSD -- a faction formerly controlled by the President and his allies -- for its weak support, with only 7 deputies voting in favor.

¶7. (C) Proxy disputes between Yushchenko and Tymoshenko now dominate the local media, as the unraveling "political truce" appears to further threaten the IMF program. The pension bill met its demise on March 3, hours after a group of BYuT deputies joined the opposition parties to vote for the ouster of Foreign Minister Ohryzko, an ally of the President, allegedly for Ohryzko's anti-Tymoshenko letter circulated to Ukraine's key embassies abroad (Ref B). On March 4, Naftohaz headquarters were raided by the state security service (SBU), which is under the control of the President, allegedly to seize documents related to controversial elements of the Tymoshenko-brokered gas deal with Russia (Ref A). On March 5, after receiving an order from the Presidential Secretariat, the Ukraine NATO mission refused to credential DPM Grigoriy Nemyria, Tymoshenko's key foreign policy advisor, as he sought access to the compound to participate in the NATO-Ukraine Council Ministerial with Acting Foreign Minister Khandogiy in Brussels. Nemyria had traveled to

represent Tymoshenko, thus the "gate incident" has been interpreted as a slap in the government's face.

¶8. (C) Note: Rada Speaker Lytvyn saw the disintegration of Yushchenko/Tymoshenko cooperation coming, when he spoke to the Ambassador on March 4. He worried that Ukraine would "go down in chaos," with each faction leader looking to capitalize on the mistakes of others. He had predicted that the Ohryzko dismissal would lead to more destabilization of an already fragile "pretense" of unity. End note.

¶9. (C) The IMF, World Bank, and G7 ambassadors told PM Tymoshenko -- repeating what they had stated to the President on February 26 -- that an "on track" IMF program remains a pre-condition to any external budget support. The PM asked the assembled group to take into account Ukraine's "special (political) circumstances" that "will not change." The PM admitted that it would be a "tragedy" if Ukraine failed to renew its cooperation with the IMF, and she said that she would continue to reach out to the U.S. and the E.U. for financial assistance, knowing that such support was conditioned on a prior agreement with the IMF. She admitted that Ukraine was in ongoing negotiations with the Russians for a bilateral loan. Yet, the PM suggested that Russia was in a worse economic condition than Ukraine, and she predicted that Russia would face an avalanche of financing obligations in the months to come.

¶10. (C) Comment. That the IMF program is in trouble is no surprise, especially since the second tranche of a \$16.4 billion Stand-By Arrangement (SBA) has been on hold for several weeks due to the lack of GOU action on the IMF's conditionalities. Nonetheless, to our knowledge, the IMF had not previously told the President or the PM that the Fund would indefinitely withhold the return of its Ukraine mission team. The longer the IMF mission team is delayed, the greater the threat of a Ukrainian financial disaster.

¶11. (C) The ball is now firmly in Kyiv's court. On the one hand, the Anti-Crisis Working Group, a roundtable process that had made some progress and generated some hope, has been unable to contain the animosity and scope of personal ambitions driving Ukraine's senior leaders. On the other hand, some sort of joint process remains essential, given the gravity of the situation and the seeming inability of Ukraine's leadership to put aside politicking for more than a few days in order to rescue the country from further decline.

We are concerned that while the G7 ambassadors plus IMF/World Bank process has helped, it no longer can substitute for higher level engagement. End comment.

TAYLOR